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IN THE

Supreme Court of the United States

October Term 1934

Nos. 176 and 177

WILLIAM E. HERRING and EULA DAY HERRING, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Your petitioners, William E. Herring and Eula Day Herring pray that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Fifth Circuit in the above entitled cases (which were numbered 7214 and 7215 in the Circuit Court of Appeals) entered April 24, 1934 (R. 46), petition for rehearing denied June 8, 1934 (R. 53). The said judgments (Judge Sibley dissenting and delivering a dissenting opinion) denied petitions for review, and affirmed decisions of the United States Board of Tax Appeals. The opinions of the court below (R. 37) are reported in 70 Fed. (2d) 785. The opinion of the Board of Tax Appeals (R. 13) was a memorandum opinion which is not officially reported. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented

In computing net taxable income for 1926 under the Revenue Act of 1926, are the petitioners entitled to deduct the statutory allowance for depletion from the advance royalties or "bonuses" received by them in 1926 from various lessees to whom ordinary oil and gas leases were granted in that year? Or must they lose that allowance because the lands leased were not producing oil or gas when the respective leases were made and because the lessees did not develop and produce oil or gas under the leases until after 1926?

Statutes and Regulations Involved

Section 214(a) 1926 Act.

> "In computing net income there shall be allowed as deductions:
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> • • • • • • • •
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> (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;"

Section 204(c) 1926 Act.

> "The basis upon which depletion, exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—
>
> (1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of

a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(2) In the case of oil and gas wells the alolwance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Art. 216, Regulations 69.

"*Depletion—Adjustments of accounts based on bonus or advanced royalty.*

"(a) *Where a lessor receives a bonus in addition

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*Article 215(a) of Regulations 45 (1918 Act) read as follows:

"Where a lessor received a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

Treasury Decision 3938, promulgated November 13, 1926, C.B. Dec. 1926, pg. 117, changed subdivision (a) to read as follows:

"Where a lessor receives a bonus in addition to royalties, there shall

to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

* * * * * * * *

"(c) §If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

* * * * * * * *

"(e) *In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

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be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

Murphy Oil Co. v. *Burnet*, 287 U. S. 299, dealt with subdivision (a) as originally promulgated and as amended.

§All regulations beginning with those under the 1918 Act have contained a provision identical with subsection (c).

*This subsection was first introduced into the regulations under the 1926 Act, due to the option contained in that Act to compute oil and gas depletion by the "percentage" method.

Statement

During the year 1926 the community estate of William E. Herring and wife owned a 50% interest in the partnership C. T. Herring & Son. For that year petitioner William E. Herring and his wife, petitioner Eula Day Herring, filed separate income tax returns under the community property laws of Texas. In 1926 the partnership owned a large tract of land in the vicinity of Amarillo, Texas, and its principal business was cattle raising. During 1926 the partnership leased portions of its land to sundry individuals and corporations for the "sole and only purpose of mining and operating for oil and gas," etc. These leases were in all respects the customary oil and gas leases (R. 30). The various lessees paid in the aggregate to the partnership lessor, in 1926, $683,793.75 as advance royalties or bonuses and agreed to pay further royalties of 1/8th of the product or its value as oil or gas was actually produced under the leases.

The lessor had no control over the time wells would be drilled by the various lessees. At the time the leases were executed and during the remainder of the year 1926 there was no oil or gas well on the land. However, in 1930 four wells were drilled, all of which were commercial gas wells, all had a showing of oil and one produced from eight to ten barrels of oil a day.

In 1926, when the leases were executed, it was highly probable that the land would, when explored, produce oil or gas or both. This is shown in the record by the fact that wells comparatively close and on all sides of the property were producing; by uncontradicted expert testimony as to geological conditions and, perhaps more convincing to those who cannot qualify as technical oil and gas men, by the fact that numerous persons and corporations engaged in the oil and gas business were willing to pay sums aggregating $683,793.75 for the privilege of exploring the property for oil and gas.

The partnership claimed its members were entitled to a

deduction in 1926 on account of depletion in the aggregate amount of $188,043.28, which represented 27½% of the advance royalties or bonus payments. Each of the present petitioners deducted from income on their income tax returns their proportionate share of the said depletion deduction claimed by the partnership. The Commissioner of Internal Revenue refused to allow the deduction on the ground that "the property on which depletion was claimed was neither proven nor producing during the year in question." The Board of Tax Appeals, in a memorandum opinion, affirmed the Commissioner on the authority of *Lizzie H. Glide,* 27 B.T.A. 1264, which held that there must be a well on the property before the lessor could be allowed the depletion deduction. The Circuit Court of Appeals, Sibley, Circuit Judge, dissenting, affirmed the Board on the ground that there was no production on the property within the taxable year.

Specification of Errors to Be Urged

1. The Court below erred in holding that advance royalties or bonuses are not subject to depletion.

2. The Court below erred in not holding that percentage depletion is based upon income, the allowance of which looks forward or backward to actual production.

3. The Court below erred in denying petitioners the reasonable allowance for depletion which the statute permits.

4. The Court below erred in affirming the Board of Tax Appeals.

Reasons for Granting the Writs

1. The majority decision below is contrary to the decisions of this Court in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Burnet* v. *Harmel,* 287 U. S. 103, and to long established Treasury Regulations.

In dealing with cost depletion the Commissioner of Internal Revenue has, since 1918, held that advance royalties or bonus payments are subject to depletion. See Article 215, Regulations 45 and 62 (1918 and 1921 Acts), Article

216 Regulations 65 and 69 (1924 and 1926 Acts). Article 216(e), Regulations 69, dealing with percentage depletion, which was first introduced into the 1926 Act, continued the established rule and specifically states that the depletion deduction may be taken by the lessor "in respect of any bonus, royalties and other income from the property," etc.*

The Regulations under the 1918 Act were questioned by the Board of Tax Appeals which held, in *Murphy Oil Co.*, 15 B.T.A. 1195, that, as a bonus bore no relationship to production, it could not be subject to a depletion deduction. The Circuit Court of Appeals for the Ninth Circuit reversed the Board in the Murphy case, 55 Fed. (2d) 17, and this Court granted certiorari.

Before this Court passed on the Murphy case it disposed of *Burnet* v. *Harmel,* 287 U. S. 103, in which present counsel contended that a bonus received for executing an oil and gas lease in Texas was taxable as "capital gain" because, under Texas law, the leases conveyed fee title to the minerals in place. In disposing of the case this Court denied the taxpayer's contention largely on the ground that the bonuses involved were advance royalties subject to depletion. There was no showing in the Harmel case that there was oil upon the property when it was leased or that production was obtained thereon in the same year or later.§

The Court in the Harmel case states (P. 111):

> "The Court below thought that the bonus payments, as distinguished from the royalties, should be treated as capital gain, apparently because it assumed that the statute authorizes a depletion allowance upon the royalties alone. See Ferguson v. Commissioner of Internal Revenue (C.C.A. 5th) 45 F. (2) 573, 577. But

*Article 215 of Regulations 45 and Article 216 of various regulations are set forth at page 3 of this petition.

§In its brief filed in the Harmel case in this Court the Government argued, without qualification, that the lessor was entitled to depletion on the advance royalty, and therefore, the advance royalty should not be taxed as capital gain.

> bonus payments to the lessor have been deemed to be subject to depletion allowances under Section 214(a) (9) Revenue Act of 1924, by Art. 216, Treasury Regulations 65, as well as under earlier acts. Section 214(a) (10), Revenue Act of 1921, Art. 215, Treasury Regulations 62. Cf. Murphy Oil Co. v. Burnet (C.C. A. 9th) 55 F. (2d) 17. The distinction, so far as we are advised, has not been taken in any other case * * * We see no basis for it."

The Court's conclusion in the Harmel case was based, to some extent, on the decision in *Work* v. *U. S.* ex rel *Mosier,* 261 U. S. 352, which held that bonuses were advance royalties.

The Harmel decision was followed shortly thereafter by the decision in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, wherein this Court was dealing with the question of whether a substantial bonus or advance royalty paid to a lessor of oil land by his lessee was non-depletable income in its entirety when received, or whether, by an allowance for depletion with respect thereto, the basic depletable value should be reduced, so that, in later years, the allowance for depletion on ordinary royalties, would be based upon such depletable value less the depletion allowable with respect to the advance royalty, instead of upon the full value, as would have been the case if no depletion had been allowable with respect to the advance royalty. This Court said (P. 302) that it was no longer open to doubt that:

> "* * * when the execution of an oil lease is followed by production of oil, the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. See Burnet v. Harmel, supra. This is obvious where royalties alone are insufficient to return the capital investment. A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, *making no provision for a reasonably anticipated production of oil on the leased premises,* would deny the 'reason-

> able allowance for depletion' which the statute provides. * * * Doubts, if any, whether the statute authorizes depletion of bonus payments have been definitely set at rest by the repeated re-enactment, without substantial changes, of the provisions of Sec. 234(a)(9) since the promulgation of treasury regulations providing for such depletion. * * * In addition, provision is made by subdivisions (c) and (d) of the Regulations, as amended, for such necessary capital readjustments as may be occasioned by the termination, abandonment or expiration of the lease before all the oil is extracted."*

In *Palmer* v. *Bender,* 287 U. S. 551, this Court held that what might be termed a "sub-lessor," who received a cash payment or over-riding royalty, or both, from his sublessee, was entitled to an allowance for "discovery" depletion, saying (P. 557):

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. * * * The benefit of it ('discovery' depletion) accrues to the discover if he operates the well as owner or lessee, or if he leases it to another. It would be an anomoly if that policy were to be defeated and all benefit of the depletion allowance withheld because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another."

In the present case, the allowance for depletion based upon a percentage of income from the property can never be made as to the royalty collected in advance unless made

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*In the *Murphy* case, the fact that oil was produced from the property during the year the bonus was collected and subsequent thereto was fortuitous, and this Court does not appear to have placed any weight on this fact. It seems clear that this Court's decision in the *Murphy* case would have been the same if the bonus or advance royalty had been collected the last moment of the tax year so that there could be no production, and, therefore, no actual depletion of oil reserves in that year.

in the year in which the advance royalty is collected. If the lessor had developed the property himself, or leased without advance royalty, but with a larger ordinary royalty, he would have been allowed depletion on all his royalties when received. The Court below denied the depletion allowance, which the taxpayer must have to place him on equal footing with others similarly situated, from a practical standpoint, solely because of the fortuitous circumstances that the oil was developed by a lessee, who chose to begin operations in a later year, even though had development not been successful, and had no "actual depletion" occurred, the allowance would have been restored to income and taxed in the year this possibility materialized.* For an actual return of his capital, Herring in this case, as was true in the Palmer case, must look alone to the production of oil for the return of his capital, but the allowance looks forward or backward to actual production.§

The controlling statute here expressly required the allowances for depletion to "be equitably apportioned between the lessor and lessee." (Sec. 214 (a) (9) Rev. Act. of 1926.)

The allowance for depletion of the type here involved is predicated primarily upon income. The allowance is 27½% of the gross income, but not more than 50% of the net income, from the property each year. Considered with the Regulations heretofore quoted, it plainly appears that the allowance depends upon receipts more than actual exhaustion of oil or gas reserves, and that, if the allowance

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*Article 216 of Regulations 69 provides: "(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

§See Judge Sibley's dissenting opinion in this case, R. 42.

be not made as the receipts come in and are taxed, the Congressional intention of allowing, over the life of the property to every one having an economic interest in the property, 27½% of their respective gross incomes therefrom cannot be carried out. On the other hand, if the allowance is made as royalties are received, any allowance not followed by actual depletion through production can be recovered and taxed by the terms of the Regulation heretofore quoted.

The majority below in the case at bar held that a lessor was not entitled to the statutory allowance for depletion with respect to advance royalties unless oil or gas was actually produced from the property during the tax year in which the advance royalties or bonus was received:

> "The depletion charge permitted as a deduction from gross income in determining taxable income 'in the case of oil and gas wells' represents the reduction, during the taxable year in question, of oil or gas in place in land in which the taxpayer has an interest. Helvering v. Falk, U. S. Sup. Ct., Jan. 15, 1934; U. S. v. Ludey, 274 U. S. 295, 302. No statutory provision which has come to our notice authorizes such a deduction to be based on an expectation, however well founded, that oil or gas remaining in place in land during the taxable year in question will be extracted in subsequent years. Depletion of oil or gas is a result of the production and sale thereof. Palmer v. Bender, 287 U. S. 551, 558." (R. 42.)

The majority opinion takes no notice of the fact that an allowance for "percentage" depletion can only be taken as to advance royalties in the year the royalties are taxed; and that, in cases where "percentage" depletion is not applied, the allowance with respect to the bonus or advance royalty *will not* be made in any other year; and that, in neither case, can subsequent allowances be increased on account of the fact that no depletion was al-

lowed on the advance royalty.* Nor does it refer to the fact that, if depletion is allowed with respect to an advance royalty, and no oil or other mineral is produced by the lessee during the life of the lease, the lessor is required to restore the allowance to his accounts and to report it as income in the year the lease is terminated.§

Petitioners' view that the majority opinion below is in conflict with the decisions of this Court heretofore mentioned is reinforced by the similar view of the minority below. Judge Sibley, in dissenting said:

> "Both (bonuses and ordinary royalties) are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. Burnet v. Harmel, 287 U. S. 103; Murphy Oil Company v. Burnet, 287 U. S. 299; Bankers Coal Co. v. Burnet, 287 U. S. 309, Palmer v. Bender, 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been that a *reasonable* allowance shall be made *according to the peculiar conditions in each case.* Construing it as to a bonus, it is said in Murphy Oil Company v. Burnet, supra, at page 307: 'Here an anticipated depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.*' * * * If the tax officer treats a bonus payment as income, he must deplete it 27½ per cent under the command of the statute." (R. 45.)

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*"Percentage" depletion, first introduced in the 1926 Revenue Act, is unique in that the total allowances to be made over the life of the property are not limited to any particular cost or basis. Under the alternate system in the 1926 law, and the only one in earlier acts since 1918, when the total allowances equalled the basis or cost, no more was allowable. "Percentage" depletion allowances are unlimited in that respect. It is therefore impossible to make up for the denial of the allowance on a bonus in a later year.

§Regulations 69, Art. 216(a) supra.

The question should be considered in the light of well-known practical facts. Among these are the following:

It is most unusual for an oil and gas lease to be made on a tract of land already producing. Such leases ordinarily are the means by which the landowner secures the exploration of his property for oil or gas, and its discovery, as well as its development and exploitation. It is the custom for "ordinary royalties" to be the same in any territory, regardless of differences in the prospect of securing oil or gas on various tracts. This difference is ordinarily adjusted in commercial transactions by the amount of the advance royalty or bonus. Cf. Work v. Mosier, 261 U. S. 352.

The Treasury Regulations which, from 1918 to 1926, have expressly provided for depletion with respect to bonuses or advance royalties (See Murphy Oil Company v. Burnet, supra) never made any distinction whatsoever because one property might be producing when leased and another undeveloped, or because production might be secured in the year the lease was made on one and not until later on another. But these practical facts must have been known to the authors of these Regulations.

It is equally well known that, in the case of most oil and gas leases, (including those involved in this case), the lessor cannot control the time development is begun. It can ordinarily be delayed by the payment of nominal rentals, during the entire primary term of the lease. Likewise, the length of time for drilling a well varies, because of depth and geological conditions, from a few days to several months.

Therefore, a regulation which is to be applied only in the most unusual case (i.e., in the case of the leasing of a property already producing), when that limitation is not plainly expressed, is, at best, a sorry practical joke played on taxpayers and Congress. A regulation which would grant an allowance for depletion equal to 27½ per cent of over $680,000. of advance royalties, if one or two hundred bar-

rels of oil, worth, perhaps, $100.00 or $200.00 had been produced in the year of leasing, and deny the allowance if no production is secured until the next year, is arbitrary and capricious. The same is true of a regulation which would grant the allowance if one lessor grants his lease early in his tax year so that a well can be, and is, completed within that year, but denies it to a neighbor similarly situated, who leases so late in the year that his equally diligent lessee cannot secure actual production until the next year. The Court is referred to the dissenting opinion below (R. 42) as well as the dissenting opinion in the Glide case, 27 B.T.A. 1264, for a more extended discussion of such inconsistencies. For convenience these dissenting opinions are presented in full in the appendix to this petition at pages 18 and 22, respectively.

Plainly, we submit, the decision below conflicts with the express holding of this Court in *Murphy Oil Company* v. *Burnet, supra,* and *Burnet* v. *Harmel, supra,* as well as the basic principles underlying the statutory provisions as announced by this Court in *Palmer* v. *Bender,* supra, and *Helvering* v. *Falk,* 291 U. S. 183.

2. The case involves an important phase of Federal Income Tax Law, which enters into the determination of innumerable pending and future tax cases. It is present in almost every case where an advance royalty or bonus is paid for an oil and gas lease. Administrative practice has been unsettled by the decision below and other rulings, chiefly administrative. A decision by this Court will prevent much litigation and will expedite the closing of numerous tax cases.

It was the administrative practice, prior to the decision of the Board of Tax Appeals in *Murphy Oil Company,* 15 B.T.A. 1195, to allow depletion on bonuses or advance royalties whether the property leased was producing when

leased, or not, and whether or not any oil or gas was produced thereafter in the tax year.*

In that case, the Board took the position that no depletion allowance could be made as to the advance royalty or bonus, even when the property was producing when leased and continued to do so, thus holding directly opposite to administrative practice.

The contention that such bonuses should be taxed as capital gain (denied by the Bureau of Internal Revenue and the Board but upheld by the Fifth Circuit in the Ferguson case, 45 Fed. (2d) 573, and the Harmel case, 56 Fed. (2d) 153 caused further confusion until this Court decided the Harmel case. Shortly thereafter this Court decided the Murphy Oil Company case.

The Bureau of Internal Revenue, endeavoring to follow, in part at least, this Court's ruling in the Murphy case, promulgated G.C.M. 11384 on January 16, 1933 (Internal Revenue Bulletin XII-3) which recognized the lessor's right to percentage depletion on an advance royalty in some cases where the property was not producing when leased, and did not produce during the year in which the advance royalty was received, provided future production was "practically assured," but denied it in those cases in which the property leased did not have more than a "speculative prospect of future oil production" at the time the lease was made and did not actually produce until a later year. (This G.C.M. is copied in full in the appendix at page 24.

The difficulities of administration of G.C.M. 11384 are immediately apparent. Taxpayers would be compelled to employ expensive experts to prove to the Government experts that when the leases were signed production was

*Except that the Bureau had, in one ruling, held that "percentage" depletion could not be allowed on an advance royalty, unless the property was actually producing at the time the lease was made. This was based on the statutory phrase "in the case of oil or gas wells * * * a reasonable allowance for depletion, etc." although this phrase was identical with that in earlier acts under which the allowance was made regardless of that factor, and although the Bureau continued to allow depletion, other than percentage depletion, in the absence of production at the date of lease.

"practically assured" and disprove that there was "not more than a speculative prospect of future production." One of the principal reasons for the adoption, in the 1926 Act, of percentage depletion in lieu of discovery depletion, was to avoid such battles of experts.

The Board of Tax Appeals, on April 26, 1933, added to the confusion by deciding *Lizzie H. Glide,* 27 B.T.A. 1264 (now pending before the Ninth Circuit). The Glide decision disregarded G.C.M. 11384 and followed the Board's previous, and repudiated, reasoning of the Murphy Oil Co. case stating (p. 1267):

> "Depletion is inseparably related to production; it denotes a consumption of the reserve by means of which income is realized, resulting in a corresponding diminution of the value of the remainder of the asset. Unless there is production, neither the quantity nor value of the recoverable asset is depleted and there is no occasion for an allowance therefor."

The dissenting opinion of Board Member Van Fossan, Lansdon and Leech concurring, in the Glide case, is printed in the appendix to this petition at page 22.

These various and conflicting views render it impossible for administrative officers, or lower courts, to apply the law uniformly and tend to delay the settlement of all cases in which the question is involved until it is finally passed upon by this Court.

ERRATUM

Since the preparation of the petition in this case counsel has been informed of the decision of the Board of Tax Appeals promulgated June 29, 1934, in the case of J. T. Sneed, Jr., 30 B.T.A. Advance Sheet No. 171, which disapproves the Treasury Department's G.C.M. 11384. It clearly illustrates the divergent views of the members of the Board of Tax Appeals and the conflict between the majority of the Board and the Bureau of Internal Revenue.

In that case oil and gas leases were made on a large ranch in 1925 and 1926. Substantial advance royalties had been secured. In prior years a gas well had been drilled, but it did not produce commercially until later years because of lack of pipe line facilities. No wells were completed in 1925 or 1926, but at the date of trial fifteen or twenty wells were producing.

The majority held that:

> "* * * Without a detailed recital of the evidence, we have found as a fact that petitioner's lands in 1925 were regarded as proven oil or gas territory. The testimony of a qualified geologist, familiar with petitioner's lands and the field in which they are situate, the charts introduced showing existing wells in adjacent territory, and the fact that gas was found on petitioner's lands convince us that future production from wells which might be drilled on those lands was practically assured in 1925. That finding brings the case squarely within one of the situations described by respondent in G.C.M. 11384, C.B. XII-1, p. 64, in which he would permit the deduction of an allowance for depletion from income received as bonuses on leases, his description being as follows: '(1) No oil being produced when the bonus was received, but future production practically assured because of nearby wells and geological indications.'
>
> "We decline to follow this view and therefore disapprove the above quoted portion of respondent's ruling."

The dissenting opinion expressed the view that G.C.M. 11384 was valid; that it applied in the case; that the Bureau of Internal Revenue and the Board of Tax Appeals had theretofore not thought it necessary to have both production and income in the same year, and that the depletion claimed should be allowed. Judge Sibley's dissenting opinion in the case at bar was cited and commended.

Copies of the Sneed opinion are filed herewith for the Court's consideration.

Counsel is reliably informed that since the conflicting rulings mentioned have appeared the Bureau of Internal Revenue has concluded that no depletion deductions should be allowed on advance royalties (in the absence of production in the same year the bonuses were received) until the decision in the case at bar becomes final.

UNITED STATES BOARD OF TAX APPEALS

J. T. SNEED, JR., PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 45694. Promulgated June 29, 1934.

1. Prior to his marriage petitioner's brother conveyed to him an interest in their father's estate, and thereafter petitioner asserted claim thereto in partition proceedings and upon distribution of the estate received certain real estate. But conveyance was made to petitioner under agreement that the lands were not to be his until he paid for them; that, until petitioner made payment, the brother might convey to another; and that the purpose of the conveyance was to put title in petitioner so that a loan could be obtained on the property and the brother's debts discharged. Thereafter, petitioner was married, and later obtained a loan on this and his own properties and paid his brother the agreed price. *Held*, the purchase was made after petitioner's marriage, and, under the laws of Texas the lands were community property.

2. Bonuses received in connection with oil and gas leases upon petitioner's separate property are his separate income.

3. Delay rentals received in connection with oil and gas leases are community income whether lands under lease were separate or community property.

4. In the absence of a producing well on property, allowance for depletion of lease bonuses denied, even though future production of properties under lease was practically assured. G. C. M. 11384 rejected; *Lizzie H. Glide*, 27 B.T.A. 1264, followed and extended.

5. Petitioner submitted to revenue agent in charge (Dallas, Texas) a signed consent to extension of statutory period for assessment of tax for 1925, but wrote in a limitation as to amount of tax. The agent notified petitioner that this limited consent was not acceptable and demanded an unmodified consent, which petitioner refused to supply. Except for a statement in the notice of deficiency, issued after the expiration of the period, stating that consent was on file, the record discloses no other action by respondent respecting the consent, and no writing evidencing his acceptance of it before the time expired. Petitioner submitted no consent after expiration of statutory period. *Held*, the modified consent relied upon by respondent is ineffective, and assessment of the deficiency determined for 1925 is barred by statute.

Harry C. Weeks, Esq., Charles F. Koeffer, Esq., and Walter G. Russell, Esq., for the petitioner.

Frank B. Schlosser, Esq., and B. B. Cannon, Esq., for the respondent.

In assailing respondent's determinations of deficiencies in income tax for 1925 and 1926 in the respective amounts of $1,168.21 and $27,917.64, petitioner contends, first, that all the lands acquired by him subsequent to his marriage are community property; second, that an interest in his father's estate was acquired by petitioner from his brother after marriage and is community property; third, that delay rentals and bonuses received in connection with oil and gas leases upon his lands were community income, whether the lands were community or separate property; and, fourth, that the amount of the delay rentals and bonuses to be included in his income should be reduced by the deduction of an allowance for depletion. With respect to the deficiency for 1925, he further contends that its collection is barred by the statute of limitations, for the reason that the consent extending the statutory period upon which respondent relies is invalid.

FINDINGS OF FACT.

Petitioner is a resident of Amarillo, Texas. He was married on June 30, 1913, and has continuously been a resident of Texas since that date. All of the income here involved was reported as community income, divided one half to each in separate returns filed by petitioner and his wife for the years here before us. His father died in March 1912. For some years prior to that date, petitioner was engaged as a partner, first with his brother, and later with his father, who bought out the brother's interest, in a partnership operating in the ranching and cattle business.

Petitioner owns a ranch of about 85,000 acres in Moore County, Texas, and various tracts of these lands are embraced in oil and gas leases granted by him during the years now before us. A part of petitioner's holdings was purchased by him prior to his marriage; additional acreage was conveyed to him in the partition of his father's estate under decree of July 28, 1913; the remainder he acquired by purchases subsequent to his marriage, the deeds thereto being in evidence as Exhibits 8 to 11, inclusive. We adopt by reference as a part of our findings, Exhibits 1 and 2, which disclose, among other things, the source and date of acquisition of the various portions of the ranch embracing oil and gas leases later granted. Only as to the leased tracts is the time of acquisition material in this controversy.

Respecting the lands acquired by petitioner upon the partition of his father's estate, we find that for some years prior to March 1912, when his father died, petitioner was engaged with him as an equal partner in the ranching and cattle business. The partnership owned a ranch of about 77,000 acres, in which a one-half interest

belonged to petitioner upon the dissolution of the partnership by the death of the father. Petitioner inherited a one-seventh interest in his father's estate, or a one-fourteenth interest in the partnership lands. Petitioner's brother, J. B. Sneed, inherited a like interest. About this time, the latter was in serious difficulty and heavily in debt. On some of his indebtedness petitioner and other relatives were secondarily liable. By deed dated June 7, 1913, recorded on June 18, 1913, acknowledging receipt of a cash consideration of $50,000, J. B. Sneed conveyed to petitioner a one-seventh undivided interest in the lands formerly owned by the partnership. (The record does not explain why J. B. Sneed purported to convey a greater interest than he had, which both parties agree upon brief was a one-seventh undivided interest in the father's estate.) The consideration recited was not in fact paid at that time. Between the brothers, it was understood that the conveyance was made for purposes of accommodation; to pass title to petitioner that he might obtain a loan secured by his lands, and with the proceeds make payment of the purchase price to J. B. Sneed, who, in turn, would then discharge his indebtedness upon which petitioner and other members of the family were secondarily liable. It was further understood between the brothers that petitioner was not to have the land unless he paid for it; that if he failed to raise the funds by which to make payment, he was to reconvey to J. B. Sneed; that the latter was free to seek another purchaser for the property in the meantime, and that petitioner would convey to that purchaser should such a sale be arranged before petitioner had paid the recited consideration. The agreement between petitioner and his brother was entirely oral.

On July 29, 1913, a decree was entered in the suit between the Sneed heirs pending in the District Court of Moore County, partitioning the lands owned by the former partnership. In those proceedings petitioner claimed as his own the interest of his brother, to which he held title, and, accordingly, that interest was included along with petitioner's partnership interest and his own inheritance in the lands vested in him, which totaled 55,847 acres (after an adjustment to the other heirs for their shortages of some 326 acres). In November 1913 petitioner borrowed $120,000, secured by deed of trust, in which Mrs. Sneed joined, upon all his lands, including the acreage received in the partition, and from these funds made payment to his brother of $50,000.

During 1925 and 1926 petitioner granted about fifty oil and gas leases covering various portions of his ranch lands. The leases were in the form and upon the terms generally used in that field, most of them carrying provisions for bonuses and delay rentals. During

these years petitioner devoted about three fourths of his time to conferences with prospective lessees and other matters incident to the granting of the leases, most of which were negotiated through a broker.

In 1925 petitioner received bonuses of $10,400 and delay rentals of $10,364, a total of $20,764, of which respondent has treated $20,164 as separate income and the balance, $600, as community income. In 1926 he received bonuses of $210,857.18, and delay rentals of $26,605.11, a total of $237,462.29, of which respondent has treated $180,218.29 as separate income and the balance, $57,244, as community income. Expenses in connection with the making of the leases aggregated $559 in 1925 and $23,860 in 1926. These amounts were allowed by respondent as deductions from income, divided between separate and community income in the same ratio as he divided the bonuses and rentals. No dispute exists respecting the amounts received as bonuses and rentals, nor as to the amount of the expenses, the whole controversy being as to the status of the income, whether community or separate, and the allocation of the expenses between the two estates. Exhibits 1 and 2, previously mentioned, show in detail the leases from which the bonuses and rentals arose. The income arising from leases of lands owned by petitioner prior to his marriage, from leases upon lands acquired by him in the partition of his father's estate (including the acreage representing the interest purchased from J. B. Sneed), and a part of the income arising from leases of lands purchased by him after marriage, respondent has treated as separate income.

In 1922 a gas well was brought in on a lease previously granted embracing a tract nearly in the center of petitioner's lands. While the well was capable of producing (though whether in paying commercial quantities we do not know), no gas was removed during the years 1925 and 1926, for no pipe line was laid until after that time. In 1925 the whole of petitioner's ranch was regarded as proven oil or gas territory, probably productive of oil or gas, or both.

Petitioner's return for the year 1925 was filed on May 14, 1926. Respondent's notice of deficiency was issued on July 18, 1929. In January 1929, the revenue agent in charge at Dallas, Texas, transmitted to petitioner the usual form of consent extending the statutory period for assessment of tax for the year 1925, requesting its execution and return. Petitioner complied with that request under date of January 5, 1929, but wrote into the consent as a limitation upon the amount of deficiency, "not exceeding the sum of $1,168.21." Thereafter, on January 10, 1929, the revenue agent wrote petitioner in part as follows:

You are advised that the waiver form as modified is not acceptable to this office, therefore, unless the taxpayer desires to submit an unqualified waiver extending the period within which an additional assessment may be made for the year 1925 to December 31, 1929, it will be necessary to transmit Agent Dubb's report to Washington for review and assessment at an early date.

* * * * * * *

Unless the enclosed waiver forms properly executed are received in this office within 10 days from the date of this letter it will be necessary to transmit the case to the Bureau at Washington for review and assessment.

Petitioner refused to execute and submit an unqualified consent. The revenue agent in charge transmitted the case to the Bureau at Washington. Respondent's notice of deficiency contains the following statement: "Consent is on file for the year 1925 extending the statutory period of limitations to December 31, 1929." Exhibit 13, submitted in evidence as a copy of the limited consent of January 5, 1929, bears the signature of petitioner but not that of respondent. Petitioner's return for the year 1925 was filed on May 14, 1926.

OPINION.

GOODRICH: It is admitted that under the Texas statutes [1] the lands purchased by petitioner prior to his marriage, his interest in the partnership lands which he owned prior to marriage, and the lands representing his interest in his father's estate were his separate property. It is clear also, and respondent inferentially admits it, that the lands purchased by petitioner subsequent to his marriage are community property. Since the record (Exhibits 1 and 2) discloses the source and date of acquisition of all the tracts under lease (and we are here concerned only with the leased lands), the classification of the lands, the income arising therefrom, and the allocation of the expenses are a simple matter, except for the property representing the interest purchased from J. B. Sneed. The time of that purchase is in controversy. Respondent determined and maintains that it was effected prior to petitioner's marriage; petitioner contends it was effected thereafter.

We are of opinion that the interest was not purchased by petitioner until subsequent to his marriage and therefore that the lands were community property. True, ostensibly this interest was conveyed to petitioner by deed of June 7, 1913, which was a short time prior to his marriage (June 30, 1913) and was claimed by him in the partition proceedings as a part of his share of his father's estate. If petitioner's ownership in the property had its inception when the deed was executed, the lands conveyed became and thereafter re-

[1] Texas Civil Statutes (1914), arts. 4621, 4622; Texas Civil Statutes (Revision 1925), arts. 4613, 4614, 4619.

mained his separate property, for the Texas rule is that the date of inception of ownership fixes the status of the property.[2] Petitioner does not question that rule, but contends that under the facts in this case his ownership did not have its inception in the passing of the deed before his marriage, but in the payment of the money thereafter. With that we agree.

The testimony is uncontradicted and convincing that the transfer of the legal title to petitioner was for the accommodation of the transferor; that the purpose was to enable petitioner to raise money by a loan, secured by him upon these lands, with which to enable J. B. Sneed to discharge the indebtedness upon which petitioner and other relatives were secondarily liable. It was with that understanding between the brothers that petitioner claimed the interest in the partition suit. As we view it, this is not a case where a bona fide conveyance is made effecting a completed sale, with payment of the consideration deferred. Petitioner was not obligated to buy the land, nor was it to be his until he paid for it. He had no option to buy, for J. B. Sneed was free. until petitioner should pay him the agreed price, to sell to any purchaser he could find. As between the parties the conveyance was not final, but conditional, and petitioner held only as trustee for security and convenience. We doubt whether the conveyance under such circumstances could have withstood an attack by creditors or other interested parties, and it is well settled that property conveyed upon trust, in which neither husband nor wife has any beneficial interest, is not community property.[3]

We conclude that no sale of the J. B. Sneed interest to petitioner was accomplished until after petitioner's marriage, when he obtained a loan and paid for the interest of his brother in the father's estate. The lands received by petitioner upon partition of that estate, totaling 55,847 acres, represented nine-fourteenths of the total acreage owned by the partnership; seven-fourteenths being petitioner's interest as a partner, one-fourteenth being his interest as an heir, and one-fourteenth being the interest he purchased from his brother (although the deed recited the brother's interest as one-seventh of the whole of the partnership lands). The lands representing the purchased interest in the estate should be classified as community property.

[2] See Speer's Law of Marital Rights in Texas, 3d ed., p. 1051; note from 17 L.R.A. (U.S.) 154 appended to decision in *Creamer* v. *Briscoe*, 101 Tex. 490 (109 S.W. 911). See also, for discussion of applicable principles, *John M. King*, 26 B.T.A. 1158; affd. 69 Fed. (2d) 639.

[3] See Speer, Law of Marital Rights in Texas, ¶ 357, p. 488; *Crenshaw* v. *Harris*, 41 S.W. 391.

We come, then, to a consideration of the controversy respecting the classification, for purposes of the tax, of the income arising from the property under the leases—the delay rentals and bonuses. Petitioner vigorously contends that these revenues are community income and should be so taxed, no matter whether the leases embraced separate or community lands. As to the bonuses, this contention heretofore has been resolved against him, for it has been determined that cash considerations paid for the execution of leases upon separate property are the separate income of the owner of the property. *James R. Parkey*, 16 B.T.A. 441; *John O'Neil*, 16 B.T.A. 614; *W. P. Ferguson*, 20 B.T.A. 130; affirmed as to this issue, 45 Fed. (2d) 578; *Oscar Chesson*, 22 B.T.A. 818 (petition for review denied, 57 Fed. (2d) 141); *E. Michna*, 24 B.T.A. 715. We are not persuaded to a deviation from this rule of decision by petitioner's argument that the character of the bonus income was changed by reason of the fact that much of his time and attention was given to the negotiation of the leases (the majority of which were consummated through brokers). See *No. 1 Oil Corp.* v. *Bass*, 283 U.S. 279; *Rose* v. *Houston*, 11 Tex. 324; *Arnold* v. *Leonard*, 114 Tex. 535; *Stephens* v. *Stephens*, 292 S.W. 291. The bonuses received should be taxed as separate or community income in accordance with the classification of the properties under lease, covered by the various leases as shown by Exhibits 1 and 2, upon which the bonuses were paid. This allocation may be made upon settlement of the case. But it is held also that no distinction exists between delay rentals arising under leases and ordinary rentals of farm lands, and that the latter are income of the marital community, notwithstanding that the lands from which they arise may be the separate property of either spouse. G.C.M. 11197, C.B. XII–1, p. 238; *John O'Neil*, *supra*, citing *Willcutt* v. *Willcutt*, 278 S.W. 236; *Caruthers* v. *Leonard*, 254 S.W. 779. Therefore, the delay rentals received during 1925 and 1926 should be taxed as community income.

Petitioner's claim for the deduction from income of an allowance for depletion of 27½ percent of the income from the properties (delay rentals and bonuses) is also controlled by prior decision. In *Lizzie H. Glide*, 27 B.T.A. 1264 (on review C.C.A., 9th Cir.), we held that depletion is inseparably related to production; that unless there is production, no depletion of reserve is in fact sustained, and no allowance therefor may be made. Here there was no production from any of the leased properties during the years before us. There was a well upon one lease it is true, but it was shut in and no gas was removed. A closed well does not produce; it does not exhaust the reserve; its mere existence does not set up production

inseparable from depletion, nor serve to exempt the case at bar from application of the effect of the *Glide* case.

But this case goes further on its facts. Without a detailed recital of the evidence, we have found as a fact that petitioner's lands in 1925 were regarded as proven oil or gas territory. The testimony of a qualified geologist, familiar with petitioner's lands and the field in which they are situate, the charts introduced showing existing wells in adjacent territory, and the fact that gas was found on petitioner's lands convince us that future production from wells which might be drilled on those lands was practically assured in 1925. That finding brings the case squarely within one of the situations described by respondent in G.C.M. 11384, C.B. XII–1, p. 64, in which he would permit the deduction of an allowance for depletion from income received as bonuses on leases, his description being as follows: "(1) No oil being produced when the bonus was received, but future production practically assured because of near-by wells and geological indications."

We decline to follow this view, and therefore disapprove the above quoted portion of respondent's ruling.

If we are correct in holding that without production there is no depletion (which, in fact, cannot be denied) and that without actual depletion there may be no allowance therefor, the probability of production from a property in the future is immaterial. Unless that production is obtained within the same taxable period in which the bonus is received, the latter must be carried into income unreduced by an allowance for depletion. We are fully cognizant of the possibility, which petitioner on brief points out, that cash considerations received in connection with the granting of leases in one year perhaps may never be reduced by a depletion allowance because production was not obtained until a later taxable period. If that situation is to be corrected, the task is for the Congress, not for respondent, nor for this Board or the courts to attempt by a straining of the plain provisions of the statute. See *Aubrey Umsted*, 28 B.T.A. 176. We conclude that petitioner may not deduct any allowance for depletion in either 1925 or 1926. This result is amply supported by the decision of the Circuit Court of Appeals for the Fifth Circuit in *Herring* v. *Commissioner*, —— Fed. (2d) —— (Apr. 24, 1934), which affirmed our memorandum decisions in Dockets 47041 and 47042 (June 29, 1933), wherein we followed the *Glide* case, *supra*.

The remaining issue relates to the validity of the consent upon which respondent apparently relied in issuing his notice of the deficiency for 1925 after the time within which, without an exten-

sion by mutual consent in writing, the assessment thereof would be barred by statute. Petitioner contends that there is no consent; that the qualified consent which he submitted was rejected by respondent.

We agree with him. The rejection of petitioner's modified consent by the revenue agent in charge, who represented and acted for respondent, was definite and unequivocal. There is no evidence before us to indicate that respondent, within the statutory period, disapproved of his agent's refusal of the offered consent or took any action evidencing a reconsideration of the refusal and a consequent acceptance of and reliance upon the consent. Nor does the record show that petitioner asked for or received any benefits by reason of his offer to agree to a waiver of the statutory period. On the contrary, his refusal to comply with respondent's demand to submit a second consent in form acceptable to respondent shows clearly that petitioner was willing that respondent proceed at once to a final determination of deficiency in the case, and to the assessment thereof unless stayed by petition to the Board, within the period allowed by law. Therefore, the consent form signed and offered by petitioner and rejected by respondent was of no effect, and prior to the expiration of the statutory period there was no agreement in writing between the parties for an extension of that period. See *American Railways Co.*, 30 B.T.A. (No. 147).

Moreover, even had respondent's rejection of the offered consent been less definite, there would still be no agreement in form prescribed by statute, for respondent has failed to sign the consent in evidence of his agreement thereto. We understand the rule to be that a consent is ineffective unless signed by or on behalf of the Commissioner, *Chadbourne & Moore*, 16 B.T.A. 961; *Melville W. Thompson*, 18 B.T.A. 1192; *Corn Products Refining Co.*, 22 B.T.A. 605; *Atlantic Mills, etc.* v. *United States*, 3 Fed. Supp. 699; *U. S. Refractories Corp.*, 23 B.T.A. 872; affd., 64 Fed. (2d) 69; 290 U.S. 591; (*contra*, *Commissioner* v. *Hind*, 52 Fed. (2d) 1075; reversing 18 B.T.A. 96; *Parker* v. *Commissioner*, 49 Fed. (2d) 254)—unless the Commissioner's written approval of the consent appears elsewhere or can be reasonably inferred. *Stearns Co.* v. *United States*, 291 U.S. 54.

Here, the consent is not signed by or for respondent, and his only writing which could possibly record his approval or from which his approval could possibly be inferred, is the deficiency notice issued on July 18, 1929, after the statutory period had expired. Consequently, it cannot be said that before the period expired the parties had consented in writing to an extension of the time. Nor can it be said that both consented in writing *after* the time prescribed as permitted by

section 278 (c), 1924 Act, for petitioner submitted no consent except that of January 5, 1929. Respondent's notice of a deficiency for the year 1925 came too late.

Reviewed by the Board.

Judgment will be entered under Rule 50.

ARUNDELL, dissenting: For the reasons so ably set forth by Judge Sibley in *Herring* v. *Commissioner*, — Fed. (2d) — (Apr. 24, 1934), I disagree with the majority opinion in this case in disallowing depletion to taxpayer. Under the practice of the Bureau of Internal Revenue and the decisions of the Board, depletion allowances are treated as more intimately connected with income from the property than with actual production. That is, it has not been thought necessary to have both production and income in the same year in order for depletion deductions to be allowable. See *Clearfield Lumber Co.*, 3 B.T.A. 1282; *R. M. Waggoner*, 5 B.T.A. 1191; *Inspiration Consolidated Copper Co.*, 11 B.T.A. 1425; A.R.M. 12, C.B. 2, p. 144. While the rule of those cases perhaps should not be extended to situations where there is no production within a reasonable time after payment of a bonus, the Commissioner has interpreted the statute to apply to cases where production is practically assured. G.C.M. 11384, C.B. XII–1, p. 64. This ruling, promulgated after *Murphy Oil Co.* v. *Burnet*, 287 U.S. 299, is designed to give the reasonable allowance required by the statute. The facts in this case show that production was practically assured, and it also appears in the record, though not found as a fact, that fifteen or twenty wells have since been drilled, all producing or capable of production. I think the Commissioner's ruling to be sound, and as it concededly applies to this case it is error to deny deductions for depletion against the bonuses.

LEECH agrees with this dissent.

CONCLUSION

For the reasons stated the writs should issue.

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July 14, 1934.

APPENDIX

Dissenting Opinion of Judge Sibley in Herring Case

"SIBLEY, Circuit Judge, Dissenting:

"The question is whether a percentage depletion is allowable on bonuses received in 1926 for oil and gas leases which are to endure so long as oil or gas is produced when no well was drilled and no oil produced under them during that year, although the oil and gas were present and were produced later. The Board of Tax Appeals denied the allowance because there was no well, and this court denies it because no oil was taken out. One of the pertinent provisions of the Revenue Act of 1926, 'In computing net income there shall be allowed a deduction . . . in the case of mines, oil and gas wells, and other mineral deposits and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case,' occurred in previous acts. The other provision: 'In case of oil and gas wells the allowance for depletion shall be 27½ percentum of the gross income from the property during the taxable year,' is new. Great difficulty was found under the former provision in estimating the content of an oil and gas reserve under the ground and in arriving at what proportion of it was represented by the operations of a particular taxable year, and also in fixing the value of the reserve under the rules relating to discovery value. To avoid these difficulties Congress in the new provision ignored both the size and the value of the reserve, assumed that the value of any production of oil or gas would on the average be 27½ percent original capital investment not to be taxed, and the remaining 62½ percent would be taxable income, and provided for its taxation in the year it was received. It is evident that the 27½ percent deduction which the statute not only permits but commands must be made in the year that the income which measures it is received and taxed, that it cannot be taken any subsequent year, and that it is entirely independent of actual deple-

tion, being so named because it looks forward or backward to the exhaustion represented by the income received. The purpose and command of the provision is defeated by the decision in this case. The oil and gas were present to be produced, as was of course supposed when nearly a half-million dollars were paid in advance for them as bonuses, and as was proven when the wells were drilled. That the lessees by their own choice not to drill the first year should control the taxability of the lessor's bonuses, or that the depletion allowance on the entire bonuses should depend on the production in the taxable year of a few gallons of oil or a few feet of gas seems to me both unreasonable under the general provision for depletion and in contradiction of the special provision for the percentage deduction.

"It is true that depletion, like depreciation because of wear and tear and obsolescence, is based on the actual gradual loss of capital. The allowance for wear and tear and obsolescence is, however, always estimated and distributed over the useful life of the property considered, and does not depend on a demonstration of what actually happened to it in the particular taxable year. The allowance for them is a general offset against all income for the taxable year rather than a deduction from some particular item of income, because wear and tear and obsolescence, although a loss of capital, do not directly produce any particular income. Depletion also may sometimes be a mere loss, as when oil or gas runs to waste or standing timber dies and rots. But ordinarily depletion refers to a commercial use of part of a reserved store, as where ore or gas or oil is extracted for sale, or timber or ore or oil is manufactured into lumber or metal or gasoline and sold. In such cases the capital represented by the depletion is used directly to produce income and is converted into it. According to *Eisner* v. *McComber,* 252 U. S. 189, only gain is taxable income under the Sixteenth Amendment where a conversion of property is involved. Congress is

therefore merely staying on safe constitutional ground in providing for this percentage depletion against income received from oil and gas. If not a constitutional necessity, it is certainly more reasonable, where income is produced by a commercial depletion, to deduct the depletion from the particular income produced by it as an element of cost rather than to make it an offset against general income in some other year. If for example the owner of timber leases it to a sawmiller to be exhausted over a term of years and is paid as the timber is cut, the actual depletion of his timber by cutting corresponds with his receipt of income and no problem is presented. But if the sawmiller should pay for all after the end of the term, it would be unreasonable to allow the owner depletion in the years the timber was cut when he had no income and no tax to pay, and to tax his whole income without any depletion at the end. So if the whole timber should be paid for in advance. Again, if the timber owner is cutting and selling his own timber, he should be allowed to deduct the value of his timber from the income as received, no matter when the trees were cut or delivered. Although oil and gas are underground and timber is not, both are by the statute depletable and the same principle applies. The bonus on an oil and gas lease is so far as authority can make it merely royalties paid in advance, and both bonus and royalties are the consideration for the oil expected to be recovered by the lessee. Both are equally income to the lessor from his land, and both are alike subject to be reduced by allowance for depletion. *Burnett* v. *Harmel,* 287 U. S. 103; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Bankers Coal Co.* v. *Burnet,* 287 U. S. 309; *Palmer* v. *Bender,* 287 U. S. 551. The income tax statutes have studiously endeavored to tax net income only, and to make just allowances for expenses and for a return of capital lost in producing it. The statute in question nowhere says that the depletion allowance commanded is to be taken when the oil is extracted, but the general provision has always been

that a *reasonable* allowance shall be made *according to the peculiar conditions of each case.* Construing it as to a bonus, it is said in *Murphy Oil Co.* v. *Burnet, supra,* at page 307: 'Here an *anticipated* depletion of capital is to be returned from bonus and future royalties to the extent the applicable statutes allow, and the problem is to allocate such *anticipated depletion* to a payment made in *advance of its occurrence.* The allocation is permitted by statute.' This language is quite at variance with that of the court below quoted in the majority opinion. When this provision was first enacted in 1918, Regulation 45, Art. 215 (d), provided that on the expiration or abandonment of a lease *without the removal* of any or all of the mineral contemplated by the lease, there must a return to capital account of so much of the *bonus* deducted from the recoverable capital as *exceeds actual depletion,* and that amount must be treated as income the year the lease was ended. This shows that it was understood that the bonus payment was considered depletable in advance of actual depletion, and that if the contemplated depletion does not occur the correction is to be made at the end of the lease. The same Regulation has been continued ever since, as Congress has reenacted the same depletion provision, and it is referred to and its operation approved in *Murphy Oil Co.* v. *Burnet,* supra, at page 304, and again at page 306. The statutory words: 'In case of oil and gas wells' are directly connected with 'or other mineral deposits.' Wells as such were not in the mind of Congress as subjects of depletion, but the deposits of oil and gas and other minerals were in mind, and as shown above, depletion of bonuses on leases was regularly allowed although in most cases, no doubt, actual production is not accmplished in the year the lease is made. When in the Act of 1926 Congress again used the expression, 'In case of oil and gas wells' in connection with the percentage depletion no narrower meaning is to be attributed to it. *United States v. Dakota-Montana Oil Co.,* 288

U. S. 459. On the contrary, even more plainly the receipt of income and not the existence of a well or of production from it is made the generating cause of the depletion allowance. If the tax officer treats a bonus payment as income, he must deplete it 27½ percent under the command of the statute.

"In *Helvering* v. *Falk* .... U. S. ...., depletion under all the Acts through that of 1926 was under consideration and the cases were reviewed with this conclusion: 'Whatever may be said concerning the power of Congress to treat the entire proceeds of a mine as income, obviously the statute has not undertaken to do so. The plain purpose we think was to tax only that portion of the proceeds remaining after proper allowance for depletion. This allowance represents property consumed, is treated as if capital assets, and no tax is laid upon it. The statute must be so applied in practice as to carry out this purpose.' The judgment in the case at bar defeats the statutory purpose and by denying the allowance which the statute commands taxes that part of the money received which ought to be treated as if capital assets."

Dissenting Opinion in Lizzie H. Glide Case

"VAN FOSSAN, dissenting: I find it necessary to dissent from the decision of the majority. In considering the right of a taxpayer to depletion, I am unwilling to decide the question on any basis so highly technical and artificial as that employed in the prevailing opinion. Under the reasoning of the majority, the right to depletion depends on the existence of a well on the property. Obviously the production of the well, provided there be a well, need bear no relation to the amount of depletion. The law allows a flat percentage of income from the property (not from the well) as depletion. The Supreme Court has held that a bonus is income. Therefore if the bonus be paid and there happens to be a well in existence (however inconsequential the pro-

duction) the taxpayer gets full statutory depletion. If there be no well, regardless of other conditions, the taxpayer gets no depletion. But assume a case where, as frequently happens, a bonus is paid in one year and there is no well completed until the next year. The taxpayer would get no depletion on account of the bonus (or advance royalties, as the Supreme Court has called them) because there was no well on the property though all surrounding property bore productive wells, nor would he get depletion of the bonus in the next year even if a producing well be completed, because the bonus was not income in that year. Variations of this illustration, emphasizing the absurdities of the situation, could easily be multiplied.

"I am unable to see any defensible basis for a distinction that would produce such an inequitable and illogical result. The prevailing opinion introduces a new concept into the theory of depletion and in many cases sets at naught the intention of Congress as interpreted by the decisions of the Supreme Court so far as depletion of bonuses is concerned. *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. The cited case clearly decides that a bonus is depletable and makes no suggestion that this right should be governed by such a rule as laid down by the majority. The court clearly suggests the opposite:

> "A distinction between royalties and bonus, which would allow a depletion deduction on the former but tax the latter in full as income, when received, making no provision for *a reasonably anticipated production of oil* on the leased premises would deny the 'reasonable allowance for depeletion' which the statute provides. * * * (Italics supplied.)

"Moreover, I further find myself in disagreement with the majority opinion in the summary manner in which G.C.M 11384 is disposed of. That the Commissioner is not now contending for such a rule as proposed by the majority is clear from this memorandum, which provides that de-

pletion should be allowed if future production is practically assured because of nearby wells and geological indications. Whether this interpretation is too narrow it is not necessary to discuss, but certainly it is broad enough to cover the instant case. The facts show that oil was being produced in the same township and in the same oil field. This brings the petitioner squarely within the first of the four situations referred to in the memorandum. The prevailing opinion dismisses the matter on the basis of failure of proof.

"In my opinion the majority of the Board throughout this opinion have grasped at a shadow of diction and allowed the substance of the thought and intention of Congress and the Supreme Court to escape them.

"Lansdon and Leech agree with this dissent."

G. C. M. 11384

An opinion is requested relative to the application of the decision of the United States Supreme Court in the case of *Murphy Oil Co.* v. *Burnet,* December 5, 1932 (53 S. Ct., 161), to certain situations arising in connection with the allowance of percentage depletion in the case of a bonus paid for an oil or gas lease.

Although the United States Supreme Court had before it in the Murphy case a question which arose in connection with an allowance for depletion based on cost, some of the language used by the court appears to be equally applicable to certain situations arising in connection with percentage depletion. The language referred to is as follows:

> * * * when the execution of an oil and gas lease is *followed by production of oil,* the bonus and royalties paid to the lessor both involve at least some return of his capital investment in oil in the ground, for which a depletion allowance must be made under Section 234. * * * A distinction between royalties and bonus * * * making no provision for a reasonably anticipated production of oil on the leased premises, would deny the *"reasonably anticipated production of oil"* on the

leased premises, would deny the "reasonable allowance for depletion" which the statute provides. * * * (Italics supplied.)

The four situations to which attention is called are as follows:

(1) No oil being produced when the bonus was received, but future production practically assured because of nearby wells and geological indications.

(2) No oil being produced when the bonus was received, but property became productive within the taxable year.

(3) No oil being produced when the bonus was received, and not more than a speculative prospect of future oil production at that time, but property is now known to have become productive after the taxable year.

(4) Property has never become productive.

It is stated in substance that it is the opinion of the Income Tax Unit that a practical application of the law and the regulations in the light of language used in the Murphy Oil Co. case would be to allow depletion in situations (1) and (2) and to deny it in situations (3) and (4).

After consideration of the question, this office is of the opinion that the conclusion reached by the unit is correct and should be applied in the disposition of future cases involving this issue.

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